



Doing Business in Japan: A Country Commercial Guide for U.S. Companies

Chapter 6: Investment Climate

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Openness To Foreign Investment: Few Formal Restrictions

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Japan, the world's second-largest economy, is an immense potential market for U.S. foreign direct investment (FDI). The Government of Japan (GOJ) imposes few formal restrictions on FDI in Japan, and has removed or liberalized most legal restrictions that apply to specific economic sectors. The government does not impose export-balancing requirements or other trade-related FDI measures on firms seeking to invest in Japan. Risks associated with investment in many other countries, such as expropriation and nationalization, are not an issue in Japan. Moreover, Prime Minister Koizumi's pledge to double cumulative FDI into Japan by the end of 2006 has energized GOJ efforts to promote and facilitate inward investment.

Low growth in Japan for over a decade has created many new opportunities for FDI in this extremely rich and broad market:

- Prices are down to their lowest point in a decade.
- More Japanese companies are actively looking for foreign partners to inject needed capital and know-how.
- There are distressed assets that can be profitably acquired and returned to economic viability.

The challenges facing foreign investors seeking to establish or enhance their presence in Japan — many of the most important of which are matters of private business practice rather than of government regulation — include:

- A high overall cost structure that makes market entry, exit, and expansion expensive;
- Cultural and linguistic challenges to doing business;
- Corporate practices and market rules that inhibit foreign acquisition of Japanese firms, such as insufficient financial disclosure practices, cross-holding of shares among companies belonging to the same business grouping (keiretsu), the low proportion of publicly traded common stock relative to total capital in many companies, and public attitudes about foreign takeovers;
- Exclusive buyer-supplier networks and alliances are still maintained by some “keiretsu,” which limit competition from foreign firms and domestic newcomers;
- Laws and regulations that directly or indirectly restrict the establishment of business facilities and hinder market access for foreign products, services, and FDI.
- Labor practices which inhibit labor mobility, repress productivity, and negatively impact development of skills.

All of these issues are currently being addressed in government-to-government talks, and progress is being made in many areas.

FDI in Japan has soared since the mid 1990s. In fact, FDI stock in Japan has more than tripled (on a yen basis) in the period 1998-2004, from 3.0 trillion yen at the end of 1998 to 10.1 trillion yen at the end of 2004. Reforms in the financial, communications, and distribution sectors have encouraged foreign investment into these sectors. Improvements in corporate laws, bankruptcy laws, and accounting principles have also helped attract foreign capital to Japanese companies. In 2004, FDI toward Japan reached \$7.8 billion, up from \$6.3 billion in CY 2003, but not as strong as the \$9.2 billion inflow recorded in 2002.

However, Japan continues to host the smallest amount of inward foreign investment as a proportion of total output of any major OECD nation. Foreign participation in mergers and acquisitions (M&A), which account for some 80% of FDI in other OECD countries, although on an upward trend, also lags in Japan. Meanwhile, Japan continues to run an imbalance between its inward and overseas FDI (see Table 1). Japan's direct investment abroad increased in CY 2004 to \$31.0 billion, from the \$28.8 billion level of CY 2003. Japan's relative lack of foreign investment also acts as a restraint on the expansion of imports.

In the past five years, ongoing economic restructuring (due in large part to the more competitive financial sector and greater emphasis on rate of return), and changes in Japan's financial markets contributed to growth in foreign direct investment in Japan in non-financial sectors. Distribution affiliations, joint ventures, and mergers and acquisitions involving foreign and Japanese financial services providers have accelerated rapidly, as foreign firms take advantage of business opportunities being created in Japan's financial sector as a result of the Japanese government's "Big Bang" and the U.S. government's deregulation initiative with Japan. Japanese financial firms have started to look overseas for assistance in the form of new products, technologies and capital to meet these challenges. In addition, foreign firms have stepped in to buy the assets of domestic financial services firms that have recently failed. At the same time, structural impediments to foreign investment remain, and it is not certain that inward foreign investment flows will continue to accelerate.

Acknowledging that FDI in Japan lags far behind that of other industrialized economies, the GOJ has in recent years taken some welcome steps to address investment-related problems. Of most recent significance is the GOJ initiative to revise the Commercial Code. Other legislation reforming bankruptcy procedures has provided M&A opportunities, as distressed Japanese companies are able to seek partners or buyouts. The Ministry of Economy, Trade and Industry (METI) in particular is taking seriously the challenge of attracting greater foreign investment to Japan, and the Cabinet Office is coordinating a government-wide project to develop consistent translations of laws and regulations affecting foreign investors into foreign languages, starting with English. At the regional level, a number of prefectural and city governments are intensifying their efforts to attract foreign investors.

Liberalization of Investment Restrictions

Japan has gradually eliminated most of the formal restrictions governing its FDI regime. In 1991, the GOJ amended the Foreign Exchange and Foreign Trade Control Law (which also controls foreign investment) to replace the long-standing "prior notification" requirement for all FDI with an "ex post facto notification" requirement for investment in non-restricted industries. "Prior notification" (and thus case-by-case approval) is now required only for investment in certain restricted sectors, including agriculture, forestry, petroleum, electrical/gas/water utilities, aerospace, telecommunications, and leather manufacturing. Administrative approval for foreign investment in some of these sectors is quite certain, while in other sectors it is likely to be subject to greater scrutiny based on "national sovereignty" or national security concerns.

U.S. investment has become increasingly common in some traditionally restricted sectors, particularly in the petroleum and telecommunications industries. The only legal restriction on foreign ownership in Japan's telecommunications sector applies to Nippon Telegraph and Telephone (NTT): foreign investment in NTT, which is now one third owned by the government of Japan, as specified by the NTT Law. In the fall of 2001, Europe's Vodafone mobile telecommunications group took control of one of Japan's competing telecommunications operators, Japan Telecom, with an \$11 billion investment that set a record as the single largest foreign investment in Japan; Vodafone subsequently sold Japan Telecom to Ripplewood, which in turn sold it to Softbank, a Japanese company. Japan's Radio Law and Broadcasting Law limit foreign investment in broadcasters to 20 percent, or at one third for a broadcasters categorized as facility-supplying. Under a revision that passed the Diet in October 2005, foreign ownership of Japanese companies investing in terrestrial broadcasters will also be counted against these limits. However, these limits do not apply to communications satellite facility owners and program suppliers or to cable television operators.

Several sections of the Japanese Antimonopoly Law (AML) are relevant to FDI. For example, chapter four of the AML includes extensive antitrust provisions pertaining to international contract notification (section 6), stockholding (sections 10, 14), interlocking corporate directorates (section 13), mergers (section 15), and acquisitions (section 16). The stated purpose of these sections is to restrict any stockholding, management, joint venture, and M&A activities that constitute unreasonable restraints on competition or involve unfair trade practices. These provisions are not intended to discriminate against foreign companies or to discourage FDI.

Limitations on Facility Development, and Availability of Investment Real Estate

While the nationwide average price of real estate has fallen for 13 consecutive years (since 1992), real estate prices in major urban areas (although less than half the 1991) are high and have begun to rise. Potential foreign investors find that high prices of commercial office space an obstacle to investment in Japan. Lack of information on land prices and ownership also impedes foreign and domestic investors, by making it harder to assess the real asset value of potential business partners or acquisition targets.

Revisions to the Securities Investment Trust Law, enacted in November, 2000, lifted the ban on real estate investment trusts (REITs) to permit marketing of mutual funds that invest in property rights. In 2005, there were about 28 REIT listed on the Tokyo Stock Exchange holding more than 3 trillion yen in real estate assets. As of June 2005, REITs owned 529 properties mostly in the Tokyo metropolitan area. REITs are increasing demand for transparency and accurate pricing in the real estate market. The Association for Real Estate Securitization (ARES) has announced that it will begin releasing investment indexes for real estate investments in major cities in 2006.

Aiming to increase the liquidity of Japanese real estate markets, over the recent years the government has progressively lowered capital gains, registration, and license taxes on real estate. In fiscal 2003, land transaction tax rates for licensing and registration were reduced from 5 percent to 1 percent (they will increase to 2 percent from 2006). Inheritance and gift taxes were also reduced to promote transfer of land and other assets from the older to the younger generation. More changes in tax policy and accounting standards could increase real estate liquidity, but the market is still hampered by the shortage of legal and accounting professionals, the lack of information on prices and income flows, and taxes that discourage real estate transactions. Beginning March 31, 2001, the Japan Institute of Certified Public Accountants introduced a standard requiring companies to write off substantial losses (50% or more) on real estate inventories acquired for sale or development, further encouraging liquidity in real estate markets.

Japan continues to restrict the development of industrial and commercial facilities in some areas in an attempt to prevent excessive concentration of development in the environs of Tokyo, Osaka, and Nagoya, and also to protect land designated as optimal for agriculture. On the other hand, many prefectural governments outside the largest urban areas will make available property in public industrial parks. Generally speaking, Japan's zoning laws give local Japanese officials and residents considerable discretionary authority to screen almost all aspects of a proposed building. These factors effectively reduce the real estate available for development and often lead to delays in construction and higher building costs.

Corporate Tax Treatment

Local branches of foreign firms are generally taxed only on corporate income derived from within Japan, whereas domestic Japanese corporations are taxed on their worldwide income. The calculations of taxable income and allowable deductions, and payments of the consumption tax (sales tax), are otherwise the same as those for domestic companies, with national treatment for foreign firms. Corporate tax rules classify corporations as either foreign or domestic depending on the location of their "registered office," which may be the same as or a proxy for -the place of incorporation. The United States has a tax treaty with Japan that generally allows Japan to tax the business profits of a U.S. resident only to the extent those profits are attributable to a "permanent establishment" in Japan, and in addition provides measures intended to mitigate double taxation. A new bilateral tax treaty between

the United States and Japan came into full force in January 2005.

Under the terms of the new bilateral tax treaty, cross-border dividends on listed stock are not subject to source country withholding tax if the parent company owns 50% or more of the foreign subsidiary. Interest on financial transactions payable to a nonresident as well as royalties paid to a foreign licensor are also no longer subject to source country withholding tax.

A special tax measure allows designated inward investors to carry over certain losses for tax purposes for ten years rather than for the normal five years. In JFY96, the scope of losses that qualify for this special measure was expanded. As part of the JFY03 Tax Reform, Japan's effective corporate tax rate, including local taxes, was reduced from 40.87% to 39.54%. Corporate tax reform proposals for FY06 abolished tax breaks for IT-related investments and created new tax incentives for advanced software investments.

The option of consolidated taxation was made available to corporations since April 1, 2002. Consolidated taxation was intended to facilitate investment and corporate restructuring, because the losses usually expected from a new venture or recently acquired subsidiary can be charged against the profits of the parent firm or holding company.

Investment Incentives

In Japan, both government and the private sector are increasingly promoting inward FDI. At a meeting in June 2002, the Cabinet established FDI promotion as one of the key strategies for revitalizing the Japanese economy and resolved to put teeth into the measures needed to attract investment. In a General Policy Speech in January 2003, Prime Minister Koizumi pledged to double the cumulative amount of FDI over five years, from 6.6 billion yen at end-2001 to 13.2 billion yen by end-2006. Following this announcement, in March 2003, the Japan Investment Council (JIC) prepared a report setting out a "Program for Promoting Foreign Direct Investment," which discussed five target sectors and 74 measures. The Japanese Government endorsed these proposals and declared it would promptly implement them. (For more details on the report, see www.investment-japan.net/index.htm.)

Based on this report, the Invest Japan Business Support Center, a one-stop office to provide investment information to foreign companies, was established in the Japan External Trade Organization (JETRO) on May 26, 2003. (More detailed information is available at www.jetro.go.jp/investjapan/. Furthermore, information desks have been established in all concerned ministries as a center for investment information and support for navigating administrative procedures.

Prior to this, in September 2002, the business sector established the Invest Japan Forum (IJF), composed of top Japanese and foreign managers. In December 2002 the IJF made recommendations for promoting FDI to the Prime Minister and the JIC. Many of these suggestions were incorporated in the JIC report. The U.S.-Japan Private Sector/Government Commission held on April 14, 2003, also shared the view that the two countries should dramatically increase FDI and follow up on the suggestions made by the IJF.

Local governments are also increasing their efforts to attract foreign capital, both through outreach to prospective foreign investors and by offering business start-up support services and limited financial incentives. Ongoing efforts to decentralize fiscal authority in Japan may

give local governments the ability to offer tax breaks in the future. JETRO supports local governments' investment promotion efforts. Detailed information on FDI promotion at the local level is available in English on the JETRO website listed above.

The Japanese Government launched the “Special Zones for Structural Reform” initiative in April 2003, and to date the GOJ has approved 548 Special Zones. Building on ideas developed by local governments and private companies, this program designates certain local areas as exempt from one or more national regulations in order to develop the areas' special features. In theory, local governments can use the Special Zones initiative to obtain regulatory exemptions that significantly improve the investment environment, such as zones that would liberalize restrictions on ownership of hospitals, schools, and agricultural enterprises or allow localities to introduce exemptions for visas/resident qualifications to expand the acceptance of foreign engineers, tourists and exchange students. In practice, however, the Special Zones Office has rejected about 70 percent of all Special Zones proposals since the start of the initiative — in most cases due to the objections of the GOJ Ministry or Agency involved. Moreover, while a handful of approved Special Zones have addressed investment climate issues, most zone applications have not sought to create significant new opportunities for foreign investors. The Headquarters for the Promotion of Special Zones for Structural Reform, however, will continue to invite ideas on new zones from all sources, including domestic and foreign governments and private enterprises.

Conversion and Transfer Policies: Generally Uninhibited

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All foreign exchange transactions to and from Japan — including transfers of profits and dividends, interest, royalties and fees, repatriation of capital, and repayment of principal — are, in principle, freely permitted unless expressly prohibited. With the April 1998 revision of the Foreign Exchange Law, Japan moved to an ex-post notification system. This means that all foreign exchange transactions (unless specifically prohibited, including certain foreign direct investments, listed in the Appendix) no longer require prior notification or approval. In addition, the law eliminated the authorized foreign exchange bank system, whereby foreign exchange transactions all had to go through certain registered banks. All other restrictions on methods of payment — including netting of settlements — were also removed, enhancing the ability of foreign and Japanese financial firms to offer a fuller range of services in Japan. This has led to lower foreign exchange transaction costs for non-financial firms as well.

Japan is an active partner in the struggle to choke off terrorist financing. In coordination with other OECD members, the GOJ is strengthening due-diligence requirements for financial institutions. A know-your-customer law was passed in 2002. These changes could have an impact on the transfer of funds.

Expropriation and Compensation: Virtually No Risk

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In the post-war period, the GOJ has not expropriated or nationalized any enterprises, with the exception of the nationalization in 1998 of two large capital-deficient banks and, in 2002, of two small failed regional banks. Expropriation or nationalization of foreign investments is unlikely in the foreseeable future.

Dispute Settlement: No Outstanding Cases in Investment Area

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There have been no major bilateral investment disputes since 1990, and there are no outstanding expropriation or nationalization cases in Japan. There have been no cases of international binding arbitration of investment disputes between foreign investors and the GOJ since 1952. Japan is a member of the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitration Awards. However, it has long been considered an inhospitable forum for international commercial arbitration. The Japan Commercial Arbitration Association, the only organization that arbitrates international trade and investment-related disputes, had 111 cases submitted to it between FY 1998 and FY 2004. In FY2004, the JCAA had 39 cases, of which 8 went to arbitration.

There are no legal restrictions on access by foreign investors to Japanese lawyers, and significant reforms in laws governing legal services and the judicial system are increasing the ability of foreign investors to obtain adequate legal advice on doing business in Japan – despite some foot-dragging on implementing rules by the Federation of Japanese Bar Associations (*Nichibenren*).

Based on the Program for Promoting Justice System Reform endorsed by the Cabinet in March 2002, the Government of Japan submitted and secured Diet passage in 2003 of legislation to promote cooperation and collaboration between Japanese lawyers (*bengoshi*) and foreign lawyers qualified under Japanese law (*gaiben*). The “Amendment to the Special Measures Law Concerning the Handling of Legal Business by Foreign Lawyers”, which took effect in April 2005, made the following changes:

- a. Eliminated the prohibition on the employment of *bengoshi* by *gaiben*;
- b. Eliminated the regulations on joint enterprises between *gaiben* and *bengoshi*; and
- c. Abolished legal provisions for specified joint enterprises (*tokutei kyodo jigyo*) and the establishment of joint enterprises between *bengoshi* or *bengoshi* professional corporations (*bengoshi hojin*) and *gaiben* (*gaikokuho kyodo jigyo*).

As a result of the enactment of the Amendment:

- a. A *gaikokuho kyodo jigyo* organized as a single law firm or as separate firms can provide integrated legal advice and legal services on any and all matters within the competence of its members;
- b. *Gaiben* and *bengoshi* or *bengoshi hojin* in *gaikokuho kyodo jigyo* can adopt a single law firm name of their choice;
- c. *Gaiben* and *bengoshi* in *gaikokuho kyodo jigyo* are free to determine the profit allocation among them freely and without restriction;
- d. *Gaiben* are permitted to hire *bengoshi* to work with them directly or in a *gaikokuho kyodo jigyo* or in a *gaikokuho-jimu-bengoshi jimusho* composed of multiple *gaiben*; and
- e. *Gaiben* and *bengoshi* continue to be permitted on an *ad hoc* basis to enter into relationships that involve the sharing of profits and expenses.

In another significant step, the Cabinet adopted in March 2002 a judicial reform program with the following results:

- To increase the number of legal professionals, the Ministry of Justice (MOJ) undertook to increase the annual number of persons who pass the Bar Examination to 1,500 by 2004 and to 3,000 by around 2010; and the Headquarters, in cooperation with the Ministry of Education, Culture, Sports, Science and Technology, introduced a new system of law schools, starting in April 2004. As of JFY 2005, seventy-four universities have established law schools.
- In 2003 the Diet passed a new Alternative Dispute Resolution (ADR) Law, including a major revision of the existing Arbitration Law and improvement of the legal framework for arbitration, including international commercial arbitration. The ADR Law will come into effect by May 31, 2007.
- To increase the speed and efficiency of civil litigation, in 2003 the Diet passed the Law Concerning Trial Facilitation which aims to reduce by half the length of time required to complete court trials through measures to promote efficient scheduling of hearings, increase significantly the number of judges and court personnel, and facilitate litigants' collection of evidence at early stages of litigation. The law took effect on July 16, 2003.
- The GOJ submitted legislation to the Diet in mid-January 2003 to reduce filing fees for civil litigation.
- The Diet passed a partial amendment of the Administrative Case Litigation Law, which came into effect on April 1, 2005, to strengthen judicial oversight over administrative agencies.
- The Diet passed the Law on the Establishment of the Intellectual Property High Court. The first Intellectual Property High Court was established in Tokyo on April 1, 2005.

More generally, Japan's civil courts enforce property and contractual rights, and the courts do not discriminate against foreign investors. However, they are sometimes ill suited for litigation of investment and business disputes. As in many other countries, Japanese courts operate rather slowly. As noted above, the Judicial Reform Promotion Headquarters is enacting a number of changes to speed the conduct of trials.

In addition, the courts lack contempt powers to compel a witness to testify or a party to comply with an injunction, and timely temporary restraining orders and preliminary injunctions are very difficult to obtain. While filing fees for large civil cases were reduced in 1992, they are still based on the amount of the claim, rather than a flat fee. Lawyers usually require large up-front payments from their clients before filing a lawsuit, with a modest contingency fee, if any, at the conclusion of litigation. Contingency fees familiar in the U.S. are relatively uncommon. A losing party can delay execution of a judgment merely by appealing, and in appeals to the high courts, additional witnesses and other evidence are sometimes allowed.

Courts do have power to encourage mediated settlements, and the courts have a supervised mediation system. Parties can manipulate this system to delay resolution, however, and because judges move frequently, continuity is often lost. As a result, it is very common for companies to settle out of court.

Performance Requirements and Incentives: None

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Japan does not maintain a system of performance requirements. Japan also maintains no formal requirements for local management participation or local control in joint ventures or other forms of direct investment, except in restricted sectors.

Right to Private Ownership and Establishment: Secure for Foreign Business

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Japan legally maintains the right for foreign and domestic private enterprises to establish and own business enterprises and engage in all forms of remunerative activity.

Protection of Intellectual Property Rights: Can Be Time-Consuming And Costly

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Protection of intellectual property rights is an integral part of every successful U.S. exporter's basic market strategy in Japan. It is necessary to file applications to register patents and trademarks in Japan to obtain protection, but prior patent filing in the United States can provide certain advantages if applications are filed promptly in Japan. A U.S. patent or trademark attorney can provide informal advice, but it is necessary to hire a Japanese lawyer or patent practitioner (*benrishi*) registered in Japan to prosecute the patent or trademark application. In conformity with international agreement, Japan maintains a non-formality principle for copyright registration — *i.e.*, registration is not a pre-condition to the establishment of copyright protection. However, the Agency of Cultural Affairs maintains a registry for such matters as date of first publication, date of creation of program works, and assignment of copyright. U.S. copyrights are recognized in Japan by international treaty. U.S.-produced semiconductor chip design-layouts are protected for ten years under a special law if they are registered with the Japanese “Industrial Property Cooperation Center” — a Japanese government-backed public corporation.

Obtaining and protecting patent and trademark rights in Japan can be time-consuming and costly, although patent fees have recently been reduced considerably. While the process to safeguard such rights might seem prohibitive, lack of protection would permit competitors both in and outside of Japan to copy a product or production process. Even when intellectual property rights have been acquired, pirating of technology and designs can occur in Japan, as in other countries. Each company in a trading or licensing agreement should understand clearly what its rights and obligations are with respect to the intellectual property rights owned or acquired by the other. Such a clear understanding helps to create a good rapport based on mutual trust, thereby ensuring the success of the trading or licensing agreement.

Patents, Trademarks, Utility Models and Designs

Unlike U.S. patent law, patents are granted to the first to file an application for a particular invention, rather than to the first to invent. Although Japan accepts filings in English (to be

followed by a Japanese translation), companies should ensure that translations of their applications are perfect, as significant negative ramifications may result from translation errors. Prompt filing in Japan is crucial because printed publication of a description of the invention anywhere in the world, or knowledge or use of the invention in Japan, prior to the filing date of the Japanese application, would preclude the grant of a patent on the application. Also, unlike the United States, where examination of patent applications is automatic, an applicant must request examination of his patent application in Japan within three years of filing.

As is true in many countries, all patent applications are published 18 months after filing. If, during the examination, the Japanese Patent Office (JPO) finds no impediment to the grant of a patent for a particular invention, it publishes the patent application in the Patent Public Gazette a second time, including any changes that have been made during the examination. Under a recent amendment to the Patent Law, parties may contest the terms of a patent grant immediately after issuance by the Patent Office (for a period of up to six months), rather than prior to registration as had been the previous practice. The patent is granted and valid for 20 years from the date the application is filed.

It takes an average of 26 months, according to the latest JPO statistics in CY 2004, in Japan from the request for examination of application to First Action. An applicant can request accelerated examination, and efforts by the Patent Office to make the documentation necessary for the preliminary research required to request accelerated examination available electronically are expected to lower the cost of such requests to the applicant. During the examination period, limited effective legal protection exists.

Japan's Trademark Law protects trademarks and service marks. As is the case with patent applications, a resident agent (usually a lawyer or patent agent) must prosecute the trademark application. And as with the processing of patent applications, Japan's trademark registration process can be slow. Any company planning on doing business in Japan should file for trademark registration as early as practicable. Japan is subject to the Madrid Protocol (effective March 14, 2000) and trademarks registered at the WIPO Secretariat will be protected among member countries.

Japan's Utility Model Law also allows registration of utility models, a form of minor patent with a 6-year term of protection, retroactive from the date of application since January 1994. A separate design law allows protection of designs, with a 15-year term of protection from the date registration was made.

Unfair Competition and Trade Secrets

The only protection available for a trademark in Japan prior to registration is under the Japanese Unfair Competition Prevention Law. Under this law, the owner of the mark must demonstrate that the mark is well known in Japan and that consumers will be confused by the use of an identical or similar mark by the unauthorized user. In 1990, Japan enacted amendments to the law that provided some protection from theft of trade secrets, such as know-how, customer lists, sales manuals, and experimental data. The law, which was amended completely in 1993, also provides for injunctions against wrongful use, acquisition, or disclosure of a trade secret by any person who knew or should have known that the information in question was misappropriated. The judicial process, however, makes the enforcement of rights without loss of trade secrets difficult.

Over-regulation in Japan continues to restrain economic growth, raise the cost of doing business, restricts competition, impedes market entry and exit, and impede investment. It also raises prices and increases the cost of living for Japanese consumers and for foreign businesses operating in Japan. Typical of highly regulated economies, the Japanese economy is still suffering from misallocation of resources, a lack of foreign investment and a lack of entrepreneurial innovation. In addition to slowing growth, government over-regulation lies at the heart of many market access and competitive problems faced by U.S. companies in Japan.

An essential prerequisite for a vibrant Japanese economy is a regulatory system that is transparent, fair, predictable and accountable. It is important that domestic and foreign firms alike have full access to information and opportunities to participate in the regulatory decision-making process. The Japanese Government made greater transparency a crosscutting theme of its Plan on the Promotion of Regulatory Reform (Cabinet Decision of March, 2004). The systemic measures set out in the Plan could contribute to needed improvements in the transparency and accountability of the Japanese regulatory system. They include the following: wide and effective use of the Public Comment Procedures for Formulating, Amending and Repealing Regulations; the strict enforcement and promotion of the use of the 1994 Administrative Procedure Law; increased transparency of administrative guidance; full and effective implementation of the Law Concerning the Disclosure of Information Retained by Administrative Agencies; expanded use of the “No Action Letter” system; comprehensive and objective evaluation of the regulatory process; and examination of the need, effects, and costs of new proposed and existing regulations.

Building on these measures, the United States in its Regulatory Reform Initiative submissions has recommended that the Japanese Government undertake additional improvements in its regulatory system to support Japan's reform efforts and to ensure universal access to government information and the policymaking process. Japan has taken welcome steps in recent years to improve its Public Comment Procedures (PCP), but as the effectiveness of these revisions remains to be seen, the United States continues to urge the GOJ to take concrete steps to ensure the spirit of the revised PCP is adhered to, including compelling Ministries and Agencies to provide minimum 30-day public comment periods unless there is a genuinely urgent need to do otherwise; seriously consider public views submitted and incorporate them into final regulations where appropriate; publish draft regulations at the earliest possible time to allow interested parties sufficient time to analyze issues and prepare meaningful public comments; and provide sufficient time between the closing of a comment period and the finalizing of regulations so that comments can in fact be incorporated. In addition, given the often-significant role of advisory councils (*shingikai*) and other government-commissioned study groups in Japanese policy development, the United States also recommends measures to increase their transparency and provide greater opportunities for public input into deliberations of these groups. The United States further recommends that Japan take further steps to enhance the effectiveness and increase the usage of Japan's no-action letter system, which provides regulated firms with an opportunity to seek clarification of an administrative agency's interpretation of laws and regulations.

The United States continues to hold bilateral working-level discussions in an effort to encourage the Japanese to promote deregulation, competition policy, and administrative reform measures that could help revive the Japanese economy, increase imports and

foreign direct investment into Japan. The reader should consult the National Trade Estimate Report on Foreign Trade Barriers, issued by the Office of the U.S. Trade Representative (USTR) on March 30, 2005, for a detailed description of Japan's regulatory regime as it affects foreign exporters and investors.

In an effort to increase the transparency of Japan's regulatory system to foreign investors, the Cabinet Office is coordinating a government-wide effort to produce consistent translations of selected Japanese laws and regulations into foreign languages, starting with English. The project encompasses the development of an English glossary of common Japanese legal terms, translations of an initial set of laws and regulations that affect foreign investors, and a single internet-based access point.

Efficient Capital Markets and Portfolio Investment: Some Restrictions

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Japan maintains no formal restrictions on inward portfolio investment, and in fact foreign capital occupies an increasingly important place in Japanese capital markets. Informal restrictions on management participation of foreign shareholders limit the attractiveness of Japan's equity market to foreign investors, although some firms have taken steps to facilitate exercise of shareholder rights by foreign investors, such as permitting electronic proxy voting.

Environment for Mergers and Acquisitions

Japan's aversion to M&A activity is fading, accelerated by the unwinding of extensive corporate cross-shareholding brought about by implementation of improved accounting standards and new government mandates that banks divest cross-held shares above a set level of holdings.

Friendly transfer of wholly-owned and majority-owned subsidiaries remains a more common form of M&A in Japan. Similarly, owner-operated unlisted firms — which traditionally would only sell out as a last resort before bankruptcy — are becoming more amenable to acquisition, including by foreigners. Particularly in the more modern, more service-oriented sectors of the economy, purchase by foreigners is less of a badge of shame than in years past.

Still, there remain a number of key factors limiting greater entry into the Japanese market through M&A with unlisted firms — including tax policy, weak accounting and disclosure practices, Japan's underdeveloped OTC stock market (which if more developed would reduce the risks involved in M&A), lack of readily available information on firms that might be acquired, and the relative shortage of M&A "infrastructure" in the form of specialists skilled in making matches and structuring M&A deals.

Two new exchanges geared towards encouraging start-ups and venture capital investments opened in Tokyo in 1999, but only one remains. The Tokyo Stock Exchange "Mothers" Exchange, with less-stringent listing criteria for emerging companies, has relatively few listed firms and suffers from lack of liquidity.

Commercial Law Revisions

A major revision of Japan's commercial laws is nearing completion. In January 2001, new laws designed to facilitate procedures for spin-offs to establish new firms and to transfer divisions from one company to another went into effect. Important legislation was passed in 2002 and 2005 that has significantly increased the flexibility of capital structure and improve corporate governance:

In 2000-2001, the Diet enacted a number of revisions to the Commercial Code to improve the methods through which companies may obtain financing and services and to provide incentives to managers and employees, including amendments:

1. Relaxing the restrictions on the size of units of stocks, including abolishing the ¥50,000 per share minimum issue price and restrictions on the minimum net assets per share at the time of stock splits;
2. Authorizing the issuance of tracking stock;
3. Eliminating the prohibition on the issuance of non-voting common stock, and increasing the limit on the total number of non-voting shares that may be issued from one-third of the total issued shares to one-half of total issued shares;
4. Substantially liberalizing restrictions on issuance of stock options, including abolishing restrictions on the recipients of stock options, maximum number of stock options that may be granted and the permissible exercise period;
5. Permitting classes of shareholders of closely held corporations that have issued more than one class of shares to elect a specified number or percentage of board members;
6. Eliminating the prohibition against transfers of new subscription rights; and
7. Eliminating the requirement for court-supervised inspection procedure for valuation of in-kind capital contributions, allowing as an alternative certifications by professionals such as lawyers, accountants or tax accountants.

In June 2005 the Diet passed a new Company Law that revises and combines Part II of the existing Commercial Code and laws governing limited liability companies (*yugen gaisha*) and audits under the Commercial Code. When the Company Law enters into force in May 2006, corporation start-up will be made easier and corporate structure more flexible, including through elimination of minimum capital requirements for joint-stock companies (*kabushiki kaisha*), the elimination of the *yugen gaisha* form and the creation of a new Limited Liability Company (LLC) form (*godo kaisha*).

Included in the new Company Law was a provision — Article 821 — which has created great uncertainty among foreign corporations that conduct their primary business through their company branches in Japan's market. As written, Article 821 appears to prohibit such branches of foreign corporations from engaging in transactions in Japan on a continuous basis. While supplementary steps were taken in Japan's Diet prior to passage of the new Company Law to assure companies that the Japanese government would not apply Article 821 to legitimate entities, legal uncertainty remains for these branches, particularly with respect to private litigation that could be brought against their directors and officers. In bilateral talks on investment and regulatory reform, the U.S. Government has urged that

Japan make revisions to the Company Law, before it comes into effect in May 2006 to remove all legal liability that Article 821 has created for legitimate branches of foreign corporations in Japan.

Improvements in Corporate Governance:

In addition, the Diet has enacted a number of revisions to the Commercial Code and the Industrial Revitalization Law to ensure efficient corporate governance, including amendments:

- Providing publicly traded companies the option of adopting U.S.-style corporate governance system instead of complying with the statutory auditor (*kansayaku*) requirement. This option requires the appointment of executive officers and the establishment of a board committee system in which at least the audit, nomination and compensation committees would be composed of a majority of outside directors. Initially available only under the Industrial Revitalization Law, which requires companies to submit their company revitalization plans to METI Minister to obtain Minister's authorization, the new measure will be available for companies in general when the new Company Law enters into force in May 2006; and
- Permitting companies to use the Internet or other electronic means to provide notices of shareholders' meetings and other similar communications to shareholders upon individual consent, and permitting shareholders to exercise their voting rights through the use of electronic devices. In addition, companies are permitted to meet their mandatory disclosure requirements for balance sheets (and profit and loss statements) by making the full text available for 5 years in an electronic format.

Cross-shareholding and M&A

Potential foreign investors in Japan frequently point out that extensive cross-shareholding (*mochiai*) in Japan greatly complicates market-based merger and acquisition transactions and reduces the potential impact of shareholder-based corporate governance. Corporate governance practices which result in senior management emphasizing internal loyalties over shareholder return can also lead to premature rejection of M&A offers. At the same time, Japanese companies are unwinding cross-shareholdings, a process that has accelerated in recent years under the pressure of difficult corporate finances and stricter accounting requirements. Similarly, more corporations are hiring outside directors and placing greater emphasis on shareholder value in their management practices.

To assist corporations in reducing the unfunded liabilities of corporate pension funds and to accelerate the unwinding of cross-shareholdings, the Japanese government implemented legislation in 2000 that allows corporations to transfer shareholdings to their related corporate pension funds. If the shares are directly transferred, the pension fund is able to properly execute shareholder rights and sell the shares if it is deemed in the best interests of the pension-holders. However, many firms prefer the alternative of indirect transfer of shares through a trust whereby the sponsoring corporation retains voting rights and effectively influences when the shares can be sold. In 2001 the GOJ created the Banks' Shareholdings Purchase Corporation to facilitate sale of bank cross-held shares.

In another useful innovation, the Diet approved amendments to the Commercial Code permitting creation of a domestic stock swap system, through which one of the parties

becomes a wholly-owned subsidiary company and the other a parent company, as well as a stock transfer system to establish a parent company. Special tax treatment has been implemented in conjunction with the creation of the stock exchange and the stock transfer system to allow deferment of taxes on capital gains on stocks at the time of exchange and transfer. To take advantage of these new rules, however, foreign investors must legally establish a Japanese subsidiary firm to act as the counterpart to the stock exchange/transfer.

Legislation to allow foreign firms — and Japanese firms operating internationally — to use similar transactions when conducting M&As based in other markets has been adopted as part of an amendment to the Industrial Revitalization Act. Unfortunately, deferred tax treatment was not part of the package. Japan's new Company Law, which passed the Diet in 2005, provides for increased flexibility in compensation for M&A transactions, including the use of cross-border stock swaps in triangular merger transactions involving Japanese public companies. These provisions will take effect in May 2007 and, if accompanied by appropriate tax measures, are expected to greatly increase the volume of international M&A transactions in Japan, provided that implementing regulations to be drafted in 2006 do not impose significant restrictions or new procedural hurdles.

Accounting and Disclosure

Accounting and disclosure standards are an extremely important element in assessing and improving any nation's environment for mergers and acquisitions. Before any merger or acquisition can take place, it is critical that the merging or purchasing corporations have the best possible information on which to make business decisions. Implementation of "Big Bang" -associated reforms since 1998 has significantly improved Japan's accounting standards.

A shift to consolidated accounting was made mandatory in FY99 and "effective control standards and influence" standards were introduced in place of conventional holding standards, expanding the range of subsidiary and affiliated companies included for the settlement of account. Consolidated disclosure of contingent liabilities, such as guarantees, began in April 1998. Since FY01 all marketable financial assets held for trading purposes including cross-shareholdings and other long-term securities holdings are recorded at market value in Japan.

Also starting in FY00, companies were required to disclose unfunded pension liabilities by valuing pension assets and liabilities at fair value. Fixed asset impairment accounting is scheduled for FY05. This new rule would require firms to record losses if the recoverable value of property, plant or equipment is significantly less than book value.

The greater focus on consolidated results and mark-to-market accounting is already having an impact and is encouraging unwinding of cross-held shares. Corporate restructuring is accelerating, and companies are rushing to reduce pension under-funding. Banks have started disposing of low-yield assets. While the recent improvement in accounting standards and growth in M&A activity have been welcome, they have also exacerbated the shortage of accounting professionals.

Taxation and M&A

Preferential tax treatment of initial public offerings remains a problem. Under current regulations, if a company is sold in an M&A transaction before an IPO listing, a 10% capital gains tax rate applies for listed stocks. (Japan adopted a standard 20% capital gains tax rate applicable from January 1, 2004. However, the capital gains tax rate on sales of listed stocks remains 10% through the end of 2007). Under a series of special measures Japan has adopted to promote venture businesses, if the founding shareholder of a qualified company sells shares in the company:

- a 10% capital gains tax rate will apply if the sale is made prior to public listing in an M&A transaction;
- a 5% rate will apply if the shares are sold by the end of 2007 *and* within three years of listing;
- from 2008, a 10% rate will apply to shares sold by the founding shareholder within three years of listing.

Bankruptcy Laws

An insolvent company in Japan can face liquidation under the Bankruptcy Act or take one of four roads to reorganization: the Civil Rehabilitation Law (*Minji Saisei Ho*), the Corporate Reorganization Law (*Kaisha Kosei Ho*), corporate reorganization (*Kaisha Seiri*) under the Commercial Code or an out-of-court creditor agreement.

In April 2000, Japan overhauled its bankruptcy law governing small and medium size firm bankruptcies by enacting the Civil Rehabilitation Law, which focuses on corporate restructuring in contrast to liquidation. The new law provides improved protection of debtor assets prior to the start of restructuring procedures, eases requirements for beginning restructuring procedures, simplifies and rationalizes procedures for the examination and determination of liabilities and improves procedures for approval of rehabilitation plans. Japan's Corporate Reorganization Law, generally used by large companies, was similarly revised in April 2003. Amendments made corporate reorganization for large companies more cost-efficient, speedy, flexible and available at an earlier stage. By removing many institutional barriers to the restructuring process, the new bankruptcy regime has already accelerated the corporate restructuring process in Japan.

In the 1990s, most corporate bankruptcies in Japan were dealt with by out-of-court creditor agreements because court procedures were lengthy and costly. Also the fact that bankruptcy trustees had limited powers to oversee restructuring meant that most judicial bankruptcies ended in liquidation, often at distress prices. In 2001, a group of Japanese bankruptcy experts published a set of private rehabilitation guidelines, modeled after the UK-based INSOL guidelines, for out of court corporate rehabilitation in Japan. Out of court workouts in Japan tend to save time and expense, although they sometimes also lack transparency and fairness. In practice, because 100 percent creditor consensus is required for out-of-court workouts and the court can sanction a reorganization plan with only a majority of creditors' approval, the last stage of an out-of-court workout is often a request for a judicial seal of approval.

Credit Markets

Domestic and foreign investors have free access to a variety of credit instruments at market rates. In general, foreign companies in Japan have not experienced significant difficulties in obtaining funding. Most foreign firms obtain short-term credit by borrowing from Japanese commercial banks or one of the many (close to one hundred) foreign banks operating in Japan. Medium-term loans are available from commercial banks, as well as from trust banks and life insurance companies. Large foreign firms have tended to use foreign sources for long-term financial needs, although increasingly sophisticated derivatives products are becoming available to assist in hedging foreign investors' perceived risk.

Political Violence: Rare to Unknown

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In general, political violence is rare in Japan, and acts of political violence involving American business interests are virtually unknown.

Corruption: Evolution Towards Stricter Ethical Standards

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The penal code of Japan covers crimes of official corruption. An individual convicted under these statutes is subject, depending on the nature of the crime, to penal servitude ranging from one month to fifteen years, and possible fines up to three million yen or mandatory confiscation of the monetary equivalent of the bribe.

While corruption usually involves the exchange of moneys, the methods by which business is conducted in Japan can often lead to what some foreign Japan-watchers have described as "institutionalized corruption." For example, the web of close relationships between Japanese companies, politicians, government organizations, and universities has been said to foster an inwardly cooperative business climate that is conducive to the awarding of contracts, positions, etc. within a tight circle of local players.

Bid-rigging activities continue. Bid rigging harms both the competitive process and Japanese taxpayers, and undermines respect for competition principles and for the Antimonopoly Act. Most damaging is government official support and assistance in bid-rigging conspiracies. The Bid-Rigging Prevention Act came into effect on January 6, 2003. That Act authorizes the Japan Fair Trade Commission (JFTC) to demand central and local government commissioning agencies to take corrective measures to prevent continued complicity of officials in bid-rigging activities, and to report such measures to the JFTC. The Act also contains provisions concerning disciplinary action against officials who have participated in bid rigging and compensation for overcharges when the officials caused damage to the government due to willful or grave negligence. However, enforcement has lagged, with only two JFTC investigations in the first two years since the Act entered into force. New ground was broken in 2005 when the JFTC invoked the Bid-rigging Prevention Act for the first time against a central government agency in the wake of a major bid-rigging scandal involving executives of the state-owned corporation in charge of highway construction and maintenance. Previous applications of the Act had been directed only at local authorities. Nevertheless, questions remain as to whether the Act's disciplinary provisions are strong enough to ensure that officials who facilitate illegal bid rigging will be held accountable.

Amakudari is the practice whereby senior government officials retire into top positions in Japanese companies, usually in industries that they once regulated. These officials then function as in-house consultants on regulatory matters and as lobbyists to their former

ministries and agencies. *Amakudari* individuals are particularly common in the financial, construction, transportation, and pharmaceutical industries — which, not coincidentally, are traditionally heavily regulated industries. Foreign companies usually do not enjoy such pipelines into the bureaucracy, and thus are somewhat disadvantaged in their ability to understand and deal with laws, regulations, and informal ministry guidance. This disadvantage has been ameliorated somewhat in recent years by the introduction of more transparent administrative procedures. In addition, egregious examples of bid-rigging undertaken through *amakudari* connections have led to efforts toward reform. Notably, following the May 2005 revelation of a major bid-rigging conspiracy tied to government tenders for steel bridge construction, both the Ministry of Land, Infrastructure, and Transport (MLIT) and the Japan Highway Public Corporation issued new, stricter guidelines on post-retirement employment by officials and executives.

While there have been some high profile exposures of officials having either given or accepted bribes, the Japanese government has not had an aggressive record of criminal prosecution. Those prosecuted have generally received suspended sentences. In some cases, the government is in the dilemma of deciding how to handle past activities such as “wining and dining” which were commonplace at the time, but which are now more explicitly banned. The recent revelation of several corruption scandals may reflect an evolution towards stricter ethical standards.

Following reform in 1993, numerous shareholder civil suits have been filed. Japanese law also provides for company directors to be found personally liable for the amount of the bribe, and some judgments have been rendered against company directors. This change may significantly impact the payment of bribes, as individuals are held personally liable without the shield of the company to protect them, although there has been discussion within the ruling political party of possible new rules to make it more difficult to file shareholder derivative lawsuits.

Japan has also ratified the OECD Anti-Bribery Convention, which bans the bribing of government officials in countries outside Japan. The OECD has identified some deficiencies in Japan's implementing legislation, some of which the Government of Japan has taken steps to rectify. In May 2004, Japan further amended the Unfair Competition Prevention Law (UCPL) to extend national jurisdiction to cover the crime of bribery. This change may facilitate enforcement action, but as of January 2006 Japan had yet to file any foreign bribery cases. The GOJ also submitted an amendment to the Organized Crime Prevention Law to provide for confiscation of bribery proceeds for consideration by the 2004 regular Diet session, but this amendment was held over to the next diet session. As of January 2006, the proposed legislation remains "under discussion" in the Diet, with no indication as to the timing of eventual passage. The GOJ has also failed to act on other changes recommended by the OECD Bribery Working Group, such as increasing the level of penalties for bribery.

Bilateral Investment Agreements: Continuing Discussions under EPG

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The 1952 U.S.-Japan Treaty of Friendship, Commerce, and Navigation gives national treatment and most favored nation treatment to most U.S. investments in Japan.

U.S.-Japan Investment Initiative

U.S. Government concerns regarding barriers to foreign investment in Japan continue to be addressed through bilateral discussions under the U.S.-Japan Economic Partnership for Growth (EPG), established by President Bush and Prime Minister Koizumi in June 2001. The Investment Initiative Working Group has conducted four full years of meetings discussing policy measures to improve the investment atmosphere in Japan and has pursued a vigorous program of public outreach. In order to increase business awareness and receptiveness to FDI, investment promotion seminars were held in the Japanese cities of Kobe, Fukuoka, and Nagoya in March 2002; Osaka and Sapporo in April 2003; Kitakyushu and Kyoto in April 2004; and Nagoya and Chiba in May 2005. Similarly, investment symposia were held in New York and Chicago in July 2002; San Francisco and Chicago in June 2003; Atlanta and Los Angeles in October 2004; and New York and San Jose, California, in November 2005.

OPIC And Other Investment Insurance Programs: Not Available

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OPIC insurance and finance programs are not available in Japan. Japan has been a member of the Multilateral Investment Guarantee Agency (MIGA) since it was established in 1988. Japan's capital subscription to the organization is the second largest among member countries, after the United States.

Labor: Toward More Flexibility

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The Japanese labor market today suffers from demographic, macro-economic, and structural pressures, which are beginning to change traditional Japanese employment practices. The regulatory philosophy that has formed Japan's post-war labor laws is also changing. Foreign investors seeking to hire highly qualified workers in Japan will welcome most of these changes.

Japanese employment practices have been said to rest on "three pillars:" lifetime employment, seniority-based wages, and enterprise unions. In fact, these three aspects of the Japanese labor market have always applied only to the larger firms, and today all three are undergoing transformation. Demographic pressures – fewer young workers and a rapidly aging labor force – as well as the need for structural changes in the Japanese economy are forcing most firms to abandon both lifetime employment guarantees and seniority-based wages in favor of merit-based pay scales and limited-term contracts. Also, although labor unions play a role in the annual determination of wage scales throughout the economy, only 19.2 % of Japanese workers were union members in 2004. In firms with less than 100 employees, only 1.2 % were unionized in 2004.

Investors should be aware of Japan's high wage structure. In 2004, workers earned an average of approximately 301,600 yen per month (0.16% decrease from the previous year) in base wages including benefits, with significant variations by education, age/seniority and position. Occupational wage differentials are much smaller than in most countries. However, according to the Ministry of Health, Labor and Welfare's statistics, base wages, including basic benefits, were only 75.4% of total wage costs in 2004. Annual summer and year-end bonuses added, on average, another 24.6%. Relatively high statutory welfare contributions are also required for basic government pensions, health and accident insurance, and unemployment insurance. Most companies also incur other employee welfare costs for family and/or transportation allowances, company-provided pension schemes, and such in-kind payments as housing for some employees. Offsetting these high

wage costs, of course, is the fact that the Japanese work force is highly educated, disciplined, loyal to their employer, and motivated to assure the economic well-being of the company.

Japanese workers have traditionally been classified as being either "regular" or "other" employees and this system is, to a considerable degree, still in place today. Regular employees are usually recruited directly from schools or universities and given an employment contract with no fixed duration. Other employees are given fixed duration employment contracts, which generally cannot exceed one year but may be renewed several times over. Still other employees include part-timers, interns, and "dispatched workers," as workers from temporary work agencies are called in Japan. Until very recently, only a few occupations could be handled by dispatched worker agencies but this is one area where Japanese labor law has in fact been deregulated, thus the number and types of dispatched workers have increased geometrically over the past several years.

The regulation of private, fee-charging employment agencies — including executive search firms — has also recently been liberalized. Although a fairly time-consuming and bureaucratic licensing procedure is still required, private employment agencies can now serve virtually the entire range of occupations. On-line, Internet based, job seeking and placement services are, however, still in their infancy in Japan — constrained at least partly by a Ministry of Labor requirement that every employment agency must personally interview each of its clients.

Defined contribution pensions, introduced in October 2001, helped promote labor mobility, as workers will be able to carry their pension funds to other jobs, but the ceiling on contributions needs to be raised to realize the full potential of the move.

Foreign-Trade Zones / Free Ports / Special Zones for Structural Reform

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Japan no longer has any free-trade zones or free ports. Customs authorities, however, do allow the bonding of some warehousing and processing facilities in certain areas adjacent to ports on a case-by-case basis. The GOJ established a law in 1992 entitled the "Law on Extraordinary Measures for the Facilitation of Imports and Foreign Direct Investment in Japan." Under the law, the GOJ helps increase access to the Japanese market for foreign goods and capital at government-designated "foreign access zones" near harbors and airports. This law will expire in May 2006, but the ruling LDP's draft Tax Revisions Omnibus Law for FY2006 may retain this "extraordinary measures" after the 1992 law's expiration. The LDP will submit the bill during the first Diet session of 2006.

In 2003 the government of Prime Minister Koizumi introduced the Special Zones for Structural Reform (SZSR) initiative with the goal of helping revitalize Japan's regional economies through locally led regulatory and structural reform. A small number of the Special Zones approved under the initiative have helped to remove regulatory barriers that limit U.S. business market entry and foreign investment into Japan; for example, Japan reduced customs overtime charges within its International Physical Distribution Zones by 50% in April, 2004. The majority of Special Zones, however, have not targeted significant market-opening opportunities for foreign investors. (For more details, see *also* the section on "Investment Incentives" under [Openness To Foreign Investment: Few Formal Restrictions](#), *supra*.)

Foreign Direct Investment Statistics: Steady Increase in Japan's FDI Stock in CY2004

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The following tables incorporate data for CY 2004 and JFY 2004 (April 2004 through March 2005) for both inward and outward foreign investment in Japan. The official statistics used until 2002 represent notification to the Ministry of Finance (MOF) of authorization by MOF of specific planned investment projects (as reported to MOF by companies), not necessarily actual flows of investment. In addition, the notification-based FDI statistics do not exclude investment that was withdrawn afterwards. Thus these figures generally exceed by a substantial amount actual investment flows as reported in Japan's balance of payments data. For those reasons, from the 2003 report we use balance-of-payments data as much as possible, particularly for the stocks of FDI. Balance of payments data, however, provide only overall FDI values by country, and do not cover industry-by-industry FDI and the number of cases of FDI. For those data, we still have to rely on MOF notification-based data. (At the same time, neither notification-based data nor balance of payments statistics capture re-investment of profits by foreign firms operating in Japan, or Japanese firms operating overseas. Therefore, according to some academic researchers, both types of official data misstate actual foreign capital investment by a wide margin.)

FDI in Japan has soared since the mid 1990s. In fact, FDI stock in Japan has more than tripled (on a yen basis) in the period 1998-2004, from 3.0 trillion yen at the end of 1998 to 10.1 trillion yen at the end of 2004. Reforms in the financial, communications, and distribution sectors have encouraged foreign investment into these sectors. Improvements in corporate laws, bankruptcy laws, and accounting principles have also helped attract foreign capital to Japanese companies. In 2004, FDI toward Japan reached \$7.8 billion, up from \$6.3 billion in CY 2003, but not as strong as the \$9.2 billion inflow recorded in 2002.

In CY 2004, Japan's FDI overseas also increased to \$31.0 billion from the previous year's level of \$28.8 billion. Japan's FDI flows to Asia increased sharply to \$10.5 billion in 2004, from \$5.0 billion in 2003, led \$5.9 billion of FDI into China and \$1.9 billion into Thailand. China consolidated its position as the number two destination for new Japanese FDI in 2004, after the U.S. Japanese FDI flows to most other regions stayed flat or declined. While the U.S. remained the top destination for new Japanese FDI in 2004, the annual flow dropped to \$7.5 billion from \$10.7 billion the previous year.

All data in the tables below is from MOF and JETRO, current as of January 2005, and converted into dollars using each year's average exchange rate: CY00 data at 107.77 yen to the dollar, CY 01 data at 121.53 yen to the dollar, CY 02 data at 125.31 yen to the dollar, CY03 data at 115.93 yen to the dollar, JFY03 data at 113.03 yen to the dollar, CY03 data at 108.19 yen to the dollar, JFY04 data at 107.49 yen to the dollar and "Cumulative Total" data as of the end of CY 2004 at 103.84 yen to the dollar.

TABLE 1a		
Annual New FDI into Japan		
<i>(Billions of Dollars Notification Basis until JFY 1999 Balance-of-Payments Basis for CY 2000, 2001, 2002, and 2003)</i>		
JFY	1993	3.08
	1994	4.16
	1995	3.83
	1996	6.84
	1997	5.53
	1998	10.47
CY	1999	21.5
	2000	8.32
	2001	6.24
	2002	9.24
	2003	6.32
	2004	7.82

TABLE 1b		
Ratio of Japan's Inward to Outward FDI Flows		
<i>(Notification Basis until JFY 1999 Balance-of-Payments Basis for CY 2000, 2001, 2002, and 2003)</i>		
JFY	1993	1:11.7
	1994	1: 9.9
	1995	1:13.4
	1996	1: 7.0
	1997	1: 9.8
	1998	1: 3.9
CY	1999	1: 3.1
	2000	1: 3.8
	2001	1: 6.1
	2002	1: 3.5
	2003	1: 4.6
	2004	1: 4.0

TABLE 2				
Foreign Direct Investment in Japan, by Country				
<i>(Millions of dollars; annual flow; balance-of-payments basis)</i>				
	CY 2002	CY 2003	CY 2004	CY 2004-End (Cumulative Total)
North America	3,128	-555	2,252	45,919
U.S.	2,564	-582	1,371	40,872
Canada	565	28	883	5,049
Europe	6,316	5,119	5,687	41,779
Netherlands	1,710	3,206	3,664	14,210
United Kingdom	541	-437	-316	2,310
Germany	555	1,755	1,166	3,915
Switzerland	1,045	-287	104	3,172
France	2,305	653	1,071	13,693
Asia	12	379	996	5,889
Thailand	-134	29	-1	48
Singapore	124	333	391	1,380
Taiwan	-23	78	73	1,605
Hong Kong	-14	38	299	2,136
South Korea	63	95	250	537
China	--	2	-9	90
Latin America	-189	1,376	-1,131	3,004
Cayman Islands	-114	1,348	-771	2,666
Brazil	0	0	19	33
Mexico	--	2	0	5
Total	9,245	6,325	7,817	97,305
<i>Note: Negative figures indicate capital outflow on a net basis.</i>				

TABLE 5				
Japanese Direct Investment Overseas, by Country				
<i>(Millions of dollars; annual flow; balance-of-payments basis)</i>				
	CY 2002	CY 2003	CY 2004	CY 2004-end (Cumulative Total)
North America	8,649	11,039	7,573	146,967
U.S.	7,592	10,733	7,530	142,302
Canada	1,057	306	43	4,665
Europe	9,764	7,969	7,081	101,886
United Kingdom	2,053	2,500	1,625	26,845
Netherlands	1,455	3,419	3,355	36,499
Germany	576	715	642	6,990
France	4,009	1,173	25	12,937
Spain	-87	145	182	1,150
Sweden	326	119	-72	1,560
Asia	8,177	4,965	10,548	76,416
Thailand	524	673	1,874	9,909
Indonesia	303	474	504	6,520
China	2,610	3,950	5,868	20,208
Singapore	1,880	454	136	11,175
Hong Kong	224	78	487	6,275
Malaysia	261	512	162	4,080
Philippines	1,094	110	6	3,296
South Korea	433	335	771	6,602
India	149	126	139	1,756
Taiwan	456	215	479	5,455
Latin America	4,072	3,208	3,133	26,588
Cayman Islands	3,457	1,659	2,746	15,008
Brazil	741	1,089	-66	4,560
Mexico	240	371	186	2,888
Oceania	1,424	1,120	1,861	15,091
Australia	1,142	946	1,654	12,844
Africa	227	436	382	1,628
South Africa	106	120	126	967
Middle East	89	38	-62	1,022
UAE	26	49	-20	39
Saudi Arabia	81	22	-38	859
Total	32,301	28,801	30,955	371,755
<i>Note: Negative figures indicate capital inflow on a net basis.</i>				

TABLE 6			
Japanese Direct Investment Overseas, by Industry			
<i>(Millions of dollars; annual flow; reporting basis)</i>			
	JFY 2002	JFY 2003	JFY 2004 (Cumulative Total)
Manufactured Goods	14,689	16,246	13,750
Electrical	3,920	5,005	2,039
Chemicals	1,916	4,749	3,530
Transport	4,916	3,013	3,601
Food	222	428	1,088
Metals	633	1,078	1,391
Machinery	1,288	956	1,108
Lumber/Pulp	240	28	119
Textiles	199	178	172
Other	1,354	810	702
Non-Manufactured Goods	21,860	19,599	21,010
Finance/Insurance	12,801	7,639	11,613
Commerce/Trade	3,694	4,315	1,884
Real Estate	1,449	1,494	370
Services	1,836	1,939	2,360
Transport	1,503	1,876	1,286
Mining	367	1,915	2,054
Construction	121	258	280
Agriculture/Forestry	7	157	38
Fisheries	56	4	24
Other	27	--	--
Total	49,257	31,487	34,548

TABLE 7							
Foreign Direct Investment in Japan relative to GDP							
<i>(FDI figures until JFY 1999 are on a notification basis, and on a balance-of-payments basis for CY 2000 through 2003)</i>							
<i>(trillion yen)</i>	JFY 1998	1999	CY 2000	2001	2002	2003	2004
(a) Nominal GDP	487.3	493.8	511.8	500.3	499.99	497.82	496.19
(b) FDI Inflow	1.34	2.4	0.90	0.76	1.16	0.73	0.85
b ÷ a (%)	0.27	0.49	0.18	0.16	0.23	0.15	0.17

Table 8	
Examples of Major Foreign Direct Investments by U.S. Companies and Other Foreign Nations' companies	
8a. Financial Services/Insurance	
Merrill Lynch	acquired Yamaichi securities
GE Capital	acquired Toho Insurance
Manulife (Canadian)	acquired Daihyaku Insurance
Ripplewood	acquired Long Term Credit Bank
AIG	acquired Chiyoda Life Insurance
Prudential	acquired Kyoei Life Insurance
City Financial, Japan	acquired assets of Marufuku (a consumer loan company)
Cerberus	acquired Aozora Bank
Goldman Sachs	capital participation in Mitsui Sumitomo Financial Group
8b. Information Technology/Telecommunications	
C and W (British/US interest)	acquired IDC
MCI World Com	greenfield investment
Level 3	greenfield investment
Time Warner/Media One	TITUS
Global One (Sprint JV with European firms)	greenfield investment
Cisco Systems	capital participation in Soft Bank
Microchip Technology	acquired assets of Fujitsu
Intel	capital participation in Nikon
Advanced Analogic Technology	established its Japanese subsidiary
RCS	established its branch office in Tokyo
Ripplewood Holdings	acquired Japan Telecom and subsequently sold to Softbank
Carlyle Group (with Kyocera and DDI)	acquired DDI Pocket
ESilicon	established its Japanese arm
Brion Technologies	established its Japanese subsidiary
iAnywhere Solutions	established its Japanese arm
Lehman Brothers	capital participation in MP Technologies
8c. Distribution/Retail/Hotel/Real Estate	
Toys-R-US	long-established player in this market, and still expanding
Costco	d°
Sports Authority	d°
GAP	d°
Disney stores	d°
Nike	d°
Amazon.com	d°
Starbucks	d°
Tully's	d°
Coach	d°
Chelsea Properties	joint venture to open five outlet malls
Pacifica Malls	d°
Cold Stone Creamery	d°

Payless Shoe Source	d°
Ripplewood	acquired Phoenix SEAGAIA Resort
Wal-Mart	business tie-up with Seiyu Supermarket
CB Richard Ellis	acquired equities of New City Corporation (a real estate company)
Colony Capital LLC	acquired from Daiei the Fukuoka Dome baseball stadium and neighboring Sea Hawk Hotel and Resort
Tetra Tech	established its Japanese arm
LoanStar	acquired Toei
LoneStar Japan Acq LLC	acquired Kokusai Motors' office building
Morgan Stanley Group and Starwood Capital Group	acquired Sapporo Hotel Enterprise
Goldman Sachs (with Dynacity)	acquired Kondo Sangyo Shinsetsu Gaisya
8d. Manufacturing	
Concord Camera	established its Japanese arm
DuPont	established a joint venture, DuPont Farm Solution, with Maruwa Bio Chemical
Steel Partners Japan Strategic Fund	capital participation in Kikkoman
Hewlett-Packard	established its Japanese subsidiary
(tie ups)	
Renault	Nissan
Ford	Mazda
GM	Suzuki
Daimler-Chrysler	Mitsubishi Motor
(acquisitions)	
GE	acquired Kawasaki LNP (Kawasaki Steel's chemical manufacturing subsidiary)
Dow Chemical	acquired Leich Hold (Dai Nippon Chemical's subsidiary)
IBM	acquired Display Technology (Toshiba's CD/LSD manufacturing subsidiary)
Solelectron	acquired NEC's PC manufacturing business department)
Micron Technology	acquired KMT Semiconductor (Kobe Steel's semiconductor manufacturing subsidiary)
Micron Technology	acquired assets of Dominion Semiconductor (Toshiba's subsidiary)
Carlyle Japan Holdings Three	acquired Kito Corporation (a manufacturer of industrial machinery)
Kodak Japan Digital Product Development	acquired Chinon Industries (a manufacturer of digital cameras)
Merck & Co.	acquired Banyu Pharmaceutical Co.
Morgan Stanley Group	acquired Tsuzuki Boseki
Oaktree Capital Management	acquired FDK

Web Resources

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Promotion of foreign direct investment (FDI) in Japan:

www.investment-japan.net/index.htm

Invest Japan Business Support Center
Japan External Trade Organization (JETRO)
www.ietro.go.jp/investjapan/

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To the best of our knowledge, the information contained in this report is accurate as of the date published. However, **The Department of Commerce** does not take responsibility for actions readers may take based on the information contained herein. Readers should always conduct their own due diligence before entering into business ventures or other commercial arrangements. **The Department of Commerce** can assist companies in these endeavors.